CORPORATE FINANCIER
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Mar 07

Half of the £40bn spent by FTSE 100 companies on acquisitions last year is unaccounted for, while new research argues that IFRS 3 has done nothing to improve transparency. **Peter Krijgsman** investigates the M&A black hole

DarkMatter

Around the time of the Nixon era, it was said that US presidents had to spend the second half of their term in office concentrating on foreign policy, because they would always run out of ideas on how to fix things at home. In the corporate world there's a parallel with mergers and acquisitions. Once a new CEO has picked the low-hanging fruits of obvious, internal improvements (that the previous incumbent had left behind), he or she starts thinking about spilling blood on the M&A battlefield.

The motives, needless to say, may be strategically sound or hollow and greedy. Accountants and accounting standards have responded to this danger with rules designed to kerb ill-considered corporate ambition and protect investors from the huge dents that they can put in shareholder value.

However, according to the study *IFRS 3 Year 1: the FTSE 100's reporting of acquired intangible assets* by brand consultants Intangible Business, the latest accounting rule to prevent M&A excesses – IFRS 3 – is having a negligible impact on the accounting practices of acquirers.

The standard was meant to tidy up the mess known as "goodwill" – the difference between a purchase price and the measurable value of the target company's assets. Goodwill is, in effect, a great sloshing bucket of cash or potential cash. Everyone knows (or thinks) there is a lot in it, but nobody knows exactly how much or why it is there at all.

A good plan... in theory

IFRS 3's role is to attempt to pin the value down more accurately, defining goodwill as "future economic benefits arising from assets that are not capable of being individually identified and separately recognised". At the same time it calls for valuation, as before, of tangible net assets like property and working capital, and intangible assets such as brands and customer loyalty.

This should, in theory, offer greater insight into companies' M&A actions, with detailed appraisals of each broad component of the price paid. In practice, according to Intangible Business, it's done nothing of the sort. Within those FTSE 100 companies using international financial reporting standards for the first time in the year ending December 31, 2005 or March 31, 2006, the consultancy says there is a woeful lack of analysis and a continuing, excessive dependence on ill-defined goodwill as justification for M&A decisions.

"The FTSE 100 spent £40bn of shareholders' money on acquisitions last year – yet failed to explain what over half of the expenditure was for," explains Thayne Forbes, joint managing director of Intangible Business. "The UK's major companies, from banks to retailers and insurance companies to TV networks, are systematically failing to comply with IFRS 3."

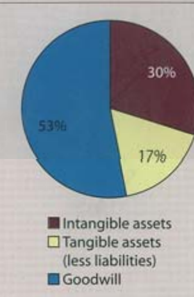
Of the companies analysed, over half the purchase prices were accounted for by goodwill, and less than a third accounted for by intangible assets. Tangible assets less liabilities accounted for just 17 per cent. Forbes believes – predictably, perhaps, for the managing director of a brand consultancy – that under-reporting of intangible asset values is the biggest part of the problem.

Sweet little mystery

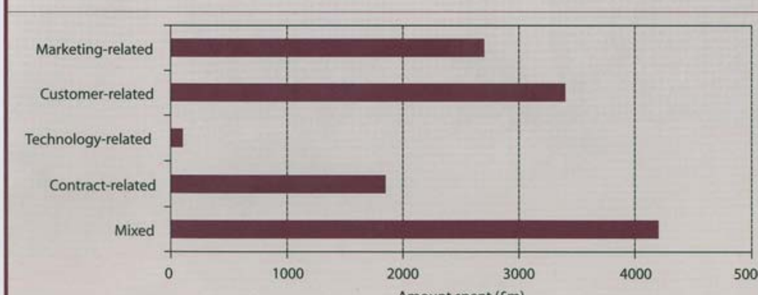
Some companies are worse than others. Cadbury Schweppes, a pioneer in brand accounting, squeezed the goodwill element in its £38m acquisition of Green & Black's down to just 18 per cent. Diageo achieved something similar in its £144m purchase of Bushmills, where goodwill was reported at 17 per cent of the acquisition price. The shareholders' "black hole" in these two deals still amounted to £30m, however, and the report says there is little description of the factors making up goodwill – estimates of head office cost savings, economies of scale and so on – in the companies' annual accounts.

People businesses, such as advertising and public relations agencies, are often the worst offenders in the misjudged M&A stakes, partly because the main assets walk out the door every evening at close of business. If employees do not enjoy working for a

➤ Acquisition accounting



➤ Breakdown of intangibles



SOURCE FOR ALL FIGURES: INTANGIBLE BUSINESS: IFRS 3: THE FIRST YEAR

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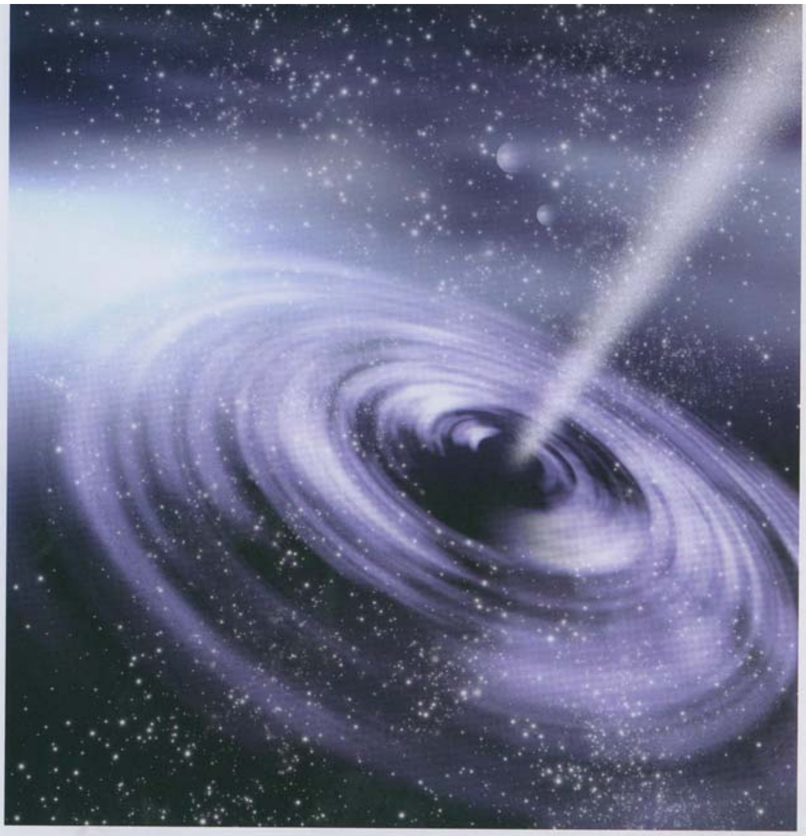
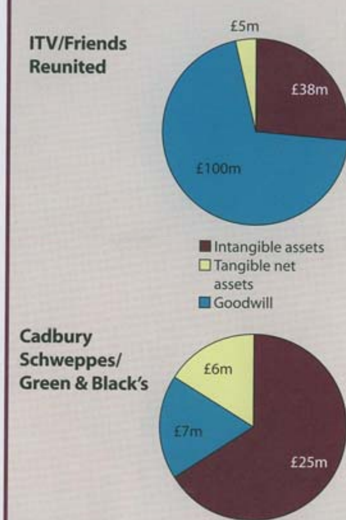


MASTERFILE

➤ Purchase price allocation under IFRS



newly merged entity, they can leave and take their clients with them.

When WPP bought Grey Global for £928m in March 2005, it allocated £936m to the goodwill account and just £319m to intangible assets. Tangible assets were negative. "There was no allocation of value to marketing-related intangibles, including brands, even though WPP is a marketing group and has accounted for brand values in the past for other similar brands such as JWT, Hill & Knowlton, Ogilvy & Mather Worldwide and the Young & Rubicam Group," the report says. "There is no real justification for the allocation to goodwill of an amount approximately equal to the acquisition cost."

ITV's £145m acquisition of Friends Reunited, meanwhile, lumped more than two-thirds of the deal price into goodwill, and just over a quarter into intangibles. Yet, as Intangible Business points out, "the driving force behind the acquisition was the Friends Reunited brand and customers".

Standard Chartered Bank did something similar with its $3.4bn purchase of Korea First Bank in April 2005. Intangible assets, especially customers using a large branch presence and a large network of cash dispensers, made up just seven per cent of the reported value of the deal. Over half was goodwill – a spend justified in the accounts with "brief references to synergies". The report also argues "intangible asset values are understated with a corresponding overstatement of goodwill. The lack of description of the factors underlying goodwill means it is impossible to understand the justification for this acquisition from the information disclosed in the accounts, which are far from transparent."

A murky picture

So what has gone wrong? Intangible Business sees a combination of specific and general reasons for the failure of IFRS 3 to produce the goods in its first year of operation.

Under the general category, it notes a lack of specialist skill in the valuation of intangible assets and a regulatory environment that bogs companies down in detailed processes and discourages genuine transparency. In the Sarbanes-Oxley world, CEOs have to carefully measure any grand pronouncements about future cost savings and synergies in case they don't come off. So they tick the lawyers' boxes instead.

> **"The UK's major companies are systematically failing to comply with IFRS 3. It has opened up a new era of creative accounting"**
>
> *Thayne Forbes, Intangible Business*

Under specific reasons, the firm detects a motive for acquiring companies to keep intangibles out of the valuation because they have to be amortised. This will act as a drag on later reported profits. Intangible assets also have to be separately valued on the balance sheet and tested each year for "impairment". The danger of a discredited brand – think of the damage done to Perrier by the benzene scare in the early 1990s – is like an unexploded landmine sitting in the company's foundations. It might not go off, but you would still rather it wasn't there.

Goodwill also has to be tested for impairment, but the sloshing bucket effect comes back into play here as it does not have to be revalued, which "gives headroom for impairment tests" and reduces the risk of having to recognise impairment charges.

In sum, then, the verdict on companies using IFRS 3 is: "Could do better, a lot better". Some commentators, such as Citigroup analysts Ken Lee and Dimitris Karydas (in the January 2007 report *M&A Manoeuvres – In the Dark? An Investors' Guide to Analysing Business Combinations in an IFRS World*), assert that the standard needs another year in situ before it can be properly judged.

But Intangible Business is gloomy. "IFRS 3 has opened up a new era of creative accounting," says Forbes. It's now up to the accountancy profession to make sure it doesn't spin out of control and contribute to another 1980s-style wave of poorly judged and poorly reported acquisitions. ■

Peter Krijgsman is a consultant and financial writer.